

The University of Chicago

THE ECONOMICS OF RAILROAD FINANCIAL REORGANIZATION

A PART OF A DISSERTATION SUBMITTED TO
THE FACULTY OF THE DIVISION OF THE
SOCIAL SCIENCES IN CANDIDACY FOR
THE DEGREE OF DOCTOR OF PHILOSOPHY

DEPARTMENT OF ECONOMICS

1938

By

WILLIAM H. MOORE

Private Edition, Distributed by
THE UNIVERSITY OF CHICAGO LIBRARIES
CHICAGO, ILLINOIS

1941

The University of Chicago

THE ECONOMICS OF RAILROAD FINANCIAL REORGANIZATION

A PART OF A DISSERTATION SUBMITTED TO
THE FACULTY OF THE DIVISION OF THE
SOCIAL SCIENCES IN CANDIDACY FOR
THE DEGREE OF DOCTOR OF PHILOSOPHY

DEPARTMENT OF ECONOMICS

1938

By

WILLIAM H. MOORE

Private Edition, Distributed by
THE UNIVERSITY OF CHICAGO LIBRARIES
CHICAGO, ILLINOIS

1941



CHAPTER XV

SUMMARY AND CONCLUSIONS

When a public board is given explicitly or implicitly the responsibility of solving a problem by applying such a test as "in the public interest" the act ought to be recognized for what it is--a transfer of authority from one group possessed of human frailties to another group possessed also of human frailties.¹ The crux of the control problem is that it is not a choice of a better or worse way of doing a thing, but a question of who is going to supply the enterprise, intelligence and integrity for solving the problem, or what is the same thing, who is going to select the persons to furnish these elements.² If the greater reliance under Section 77 upon commission control of the reorganization plans is to function better than the unreconstructed equity system, its success must rest either (a) upon the substitution of a more fortunately chosen guiding motive than the profit incentive

¹The shortsightedness of railroad bankers and managers is well publicized. The fallibility of one of the most conspicuously competent groups charged with guarding the "public interest" is courageously admitted by the Interstate Commerce Commission when, in a period of approximately two years, the Commission changed its views and confessed its earlier lack of perception of a major change in transportation:

"The views expressed in our first report in the Fifteen Per Cent Case, 1931, (178 I.C.C. 539), to the effect that motor and water competition was comparatively unimportant in the handling of freight and did not loom large in the general railroad situation, and that with recovery in business no general alarm need be felt for the future of the railroads, no longer portrays the situation" (Forty-seventh Annual Report of the Interstate Commerce, Dec. 1, 1933 [Washington: Government Printing Office, 1933], p.11).

²The issue was recognized at the time of the leading case in railroad regulation, Munn v. Illinois (94 U. S. 113 [1877]), when the New York Times, commenting on the decision, remarked: "Who shall determine the reasonableness of the charge, is the question which underlies the distrust awakened by the decision" (New York Times, Mar. 29, 1877, cited by Finkelstein, "From Munn v. Illinois and Tyson v. Banton," Columbia Law Review, XXVII [1927], 769-83).

which guides unregulated reorganizations, or (b) upon benefits arising from the omnipotence of the planning board. On the side of omnipotence, it will be well to maintain a skepticism with reference to the gains to be secured from placing the reorganization plans in the hands of an authoritarian group, for the greater capacity of one group to solve the same problems with the same tools as another group may prove illusory.

From the standpoint of motivation, the whole problem would be much simplified if the "public interest" as an objective was not itself a subjective and tenuous standard. A philosopher might very humbly shirk the responsibility of determining what is actually in the "public interest." The Interstate Commerce Commission in its fifty years of existence has established its position as an unusually competent public body, but its refusal to be bound by precedent indicates the honest qualms that any scrupulous planning body must inevitably feel in the face of the dynamic state of the practical world.³ Disregard of precedent, although perhaps a sine qua non in administrative functioning, emphasizes the vagueness of the objectives. Decisions lose consistency and tend to become rationalizations and defenses (selling talks?) in which considerations are made to appear controlling which may have been equally present, but ignored, in other cases. In the case of railroad reorganizations, the Interstate Commerce Commission has in the past disregarded the minority members who have advocated a more explicit statement of policy for the guidance of reorganizers.⁴ It is possible, but unlikely, that under its new

³For a discussion of the Commission's policy in this respect, see the section entitled "The Pragmatic Character of the Commission's Regulatory Process" in I. L. Sharfman, The Interstate Commerce Commission (New York: Commonwealth Fund, 1931), II, 367-84.

⁴In Missouri-Kansas-Texas Reorganization, 76 I.C.C. 84 at 106 (1922), Commissioner Eastman proposed a definite limitation upon bond issues. In the same case the majority opinion of the Commission stated: "It is suggested that our policy with respect to reorganizations ought to be somewhat more clearly defined. . . . It is probable that in the future, as in the past, each case of reorganization will have to be considered and disposed of on its own merits and in the light of its own conditions."

See also Denver-Rio Grande Reorganization, 90 I.C.C. 141 at 157 (1924); Securities of Louisiana Railway & Navigation Co., 99 I.C.C. 337 (1925); Chicago, St. Paul and Milwaukee Reorganization, 131 I.C.C. 673 at 694.

powers the Commission will reverse its general rule, or take a more affirmative stand.⁵

There is, no doubt, a vague consensus as to certain general objectives whenever the "public interest" is set up as an administrative criteria; in the railroad case these have been statutorily defined as the maintenance "of adequate and efficient railway transportation service at the lowest cost consistent with the furnishing of such service."⁶ In practice, however, the attainment of these ideals and, specifically, the objectives of reorganization policy is by way of an infinite series of concrete practical issues; for the solution of these concrete cases "public interest" as a rule of action has, like "reasonable," "fair," etc., an indefiniteness that throws the issue back on to "authorities."⁷ Not only do we lack a definite assurance of what constitutes our public interest, but we grasp at the device of turning over by statute to governmental commissions the task (and power) of ranking alternative procedures according to their efficacy in promoting it. Under such circumstances the practical implications are to place immeasurable confidence in the scale of values held by the regulatory commission. It is perhaps gratuitous to observe that both the solutions, and the perseverance in carrying them out, will be dictated by the education and economic philosophy of the individual authorities, no matter how scrupulously honest-intentioned or how clothed their decisions may be in terms of "fair return," "compatible with the public interest," and other phrases of similar import.

Public interest as a working rule is subject to the further

⁵The waywardness of the railroads themselves has no doubt justified the wisdom of keeping the extent of control elastic. Through their own conduct, the roads have brought about the necessity for each new extension of control. The early rate discriminations, the New Haven scandals of 1911, the St. Paul reorganization, and more recently the holding company pyramids, so outraged the public conscience that the allegation that regulation has become too restrictive has a hollow ring. The significant thing about these episodes has been that they have not been anticipated by the protectors of the public interest, but have invariably first become abuses and only then become the subject of belated proscription.

⁶Interstate Commerce Act, as amended, June 16, 1933, Section 15-a, 48 U. S. Statutes 220.

⁷Compare supra, p. 2. This reference is to the complete dissertation, which is on file only in the University of Chicago Libraries.

difficulty that the "public" in whose behalf it is exercised is not homogeneous, so that the regulatory body is usually in the position of choosing what it believes most important--shippers, workers, competitors, investors. In early days of railroad regulation the rate controversy predominated but, with present widespread holding of railroad securities and the separation of management and investment, the recognized public interest now extends to the investor groups. In reorganization the heterogeneity and antagonisms within the investor group itself are painfully apparent. Herring's statement regarding the general position of the Interstate Commerce Commission conspicuously fits the case of reorganization proceedings:

The milieu is distinctly one of special interests, and the regulatory body lives in an environment of conflicts. It must function here, not in accordance with thin, vague concepts, but in terms of concrete situations where the real content of the public interest must be extricated from a maze of technical detail. . . . The conception of the public welfare is derived in any given case from the substance presented by certain special interests.⁸

An almost inevitable consequence is that the governmental interference becomes essentially a matter of arbitrating conflicts in which the more articulate groups profit at the expense of the less articulate, in spite of the integrity of the regulatory body. Paradoxically, the group comprising the greatest number may very well prove to be the least articulate because less easily organized for determination of the question as to what really is in their interest. In theory the term "public" comes to have a halo and value connotation bringing forth a sympathetic response, whereas, in practice "the public" usually consists of elements to which the more applicable connotive term is the stigmatic one--pressure groups.

As a commentary on the efficacy of "control" of any sort, it is not to be dismissed lightly that in the reorganization proceedings under Section 77 of the Bankruptcy Act, the Interstate Commerce Commission is officiating as undertaker at the demise of securities which it was confidently hoped would be protected from such an unhappy end when, by the Transportation Act of 1920, the Interstate Commerce Commission was entrusted with the duties of

⁸E. Pendleton Herring, Public Administration and the Public Interest (New York: McGraw, 1936), pp. 183, 209.

midwife and nurse.⁹ The fervent hope that the exchange of securities at the conclusion of the pending reorganizations will prove to have been a lasting rejuvenation finds little encouragement in the record of the past. Practical considerations may have dictated the necessity for compromise with ideals in granting past approvals, but it is unrealistic to hold that, had control been by initiation rather than by veto, the same sort of practical considerations would not again have dictated the necessity for compromise.¹⁰

It is not argued that the political government ought to remain entirely passive. The democratic state has a necessary function and duty to perform in providing a framework within which men are free to make economic as well as other choices. At many points in the economic system, maladjustments can be corrected only by administrative decisions and in these cases dependence on such statutory terms as "reasonable," "unfair," and "compatible with the public interest" may help the administrative body by adding "the weight of the imponderable to a judgment arrived at upon wholly different grounds."¹¹ Every law must, of course, be writ-

⁹Transportation Act of 1920, Section 20-a, 41 U. S. Statutes 494. It would be gratuitous to point to multiplied instances, but the notoriety of the Missouri Pacific embarrassment draws attention to the fact that in the three years immediately preceding the trusteeship beginning in March, 1933, this road had issued with the approval of the Interstate Commerce Commission \$86,200,000 first and refunding bonds, less than one-half of which were for re-funding purposes. In the six years prior to the reorganization proceeding, over \$100,000,000 of new bonds were approved. All of these bonds are now in default.

¹⁰Control in the public interest raises the whole question of "planning" which has been given such a halo of desirableness in recent years. (Inferentially the antithesis of planning is "unplanning" and is therefore condemned by the rationale of the terms.) It may be urged that regulatory control is negative in approach, and that positive planning involves so much more and such different techniques that it is not in essence of the same genus. Admittedly the prospects of gain through governmental planning cannot be judged wholly on the basis of the familiar regulation of the restraining sort. On the other hand, the differences may be easily exaggerated. The restraining hand molds the plan which finally prevails, with almost as much assurance as the conception of any originator controls the realities of the consummated plan. The power to approve or disapprove the security issues of a railroad, vested in the Interstate Commerce Commission since 1920 carries with it as much responsibility for the types of financing approved as for the types disapproved.

¹¹E. Pendleton Herring, Public Administration and the Public Interest (New York: McGraw-Hill, 1936), p. 182.

ten in words, and words must be interpreted by someone--be it judges or commissioners. The less tenuous and subjective the standard set, however, the more genuine freedom there is left for men to decide for themselves in their choice of economic ends and methods of achieving those ends. When the competitive system proves inadequate for the attainment of sufferable results, the ends of liberty are best served by the exercise of the legislative power setting up rules striking at the shortcomings but under which the maximum degree of certainty exists. Although the rules of the game can be in the main whatever we choose, they assume a special significance when there are no rules or when the rules themselves are changing in such a way that certainty, even if at times punitive, is replaced by uncertainty, even if at times more equitable.¹² Where a definite, unambiguous rule is available, it is folly to incur the dangers inherent in the exercise of arbitrary, discretionary power by authorities. The choice among several possible rules is far less important than that the choice be made.

The attainment of the public interest need not conflict with, but is usually augmented by treating the constituent private interests according to definite, unambiguous and known rules. At any rate, railroad reorganization, like other cases requiring governmental intervention, merits examination to ascertain whether reliance on the authority of a regulatory commission constitutes the best method of fostering the public interest and solving the concrete differences between conflicting private interests, or whether simple, predeterminable rules are not available by which both objectives may be better achieved. Indeed, it appears that a drift away from obvious, presumptive principles has contributed to the confusion and intolerable reorganization practices which have outraged the public interest and made the regulation necessary in the first place.

The addition of Section 77 to the Uniform Bankruptcy Act was designed to correct abuses of the railroad reorganization process through recasting the forms of procedure and redistributing

¹²Cf. Mr. Justice Brandeis: "Stare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right" (Dissenting opinion, Burnet v. Coronado Oil & Gas Co., 285 U. S. 393 at 406 [1932]).

the control over the process. The old procedural technique unquestionably merited statutory efforts to purge it of its cancerous morbidities: the perversion of control over reorganization into the hands of persons characteristically lacking in fiduciary conscience; reorganization managers who seized control, drafted the plan "off-the-record," and then thrust it down the throats of the investors; protective committees who accepted fees for subserviently approving what they were asked to approve; striking minorities who capitalized their nuisance values; courts of equity who allowed themselves to be lulled into complacency by the mechanics of a fictitious foreclosure sale; and a Commission which made up in lamentations what it lacked in authority or firmness. By specifically restraining the offenders and re-dealing the powers over reorganization, the Act justifies a considerable measure of optimism concerning its probable success, judging it, of course, in the light of its limited objectives--the elimination of these invidious elements from the procedure and practice of railroad reorganization.

Although the roots of the reorganization evil lie deeper than the routine of equity or bankruptcy, Section 77 was not explicitly directed at control of the financial practices which lead to the necessity of reorganization. In that direction the Section proposes nothing specific, but falls back upon the Interstate Commerce Commission to determine the public interest and through veto, approval, or initiation of plans to find the means of advancing it. Undoubtedly there was an implicit hope, if not belief, that, through regulation of the personnel and procedure, repetition of reorganization would not again be necessary in the case of roads which had once undergone a Section 77 reorganization; but the hope of attaining such an end was left dependent upon the omniscience of the "authority" rather than upon explicit statutory proposals.

To the extent that, because of its limited purpose, the act fails to attack the capitalization methods which necessitate reorganization, Section 77 neglects ultimate objectives, and falls short of the larger ideal of preventing reorganizations entirely by making reorganization practice and procedure contribute to that end. In fact, the debtor philosophy which pervades the act actually militates against achieving that objective by failing to discourage future and continued reliance on evidences of debt for

railroad financing. Considering the time of enacting Section 77, the policy of leniency toward debtors may have been socially preferable to the alternative remedy of inflating the currency; giving debtors time to discharge the obligation or outright deflation of the debt were perhaps lesser evils than a general cheapening of money for the sake of debtor relief alone. From a longer-run point of view, however, it appears that avoidance of reorganization should be given more consideration than mere palliation of reorganization procedural exigencies.

In examining the railroad reorganization problem with the hope of finding a solution for it in as objective rules as possible, it is natural to turn to the causes of the need for reorganization. One can scarcely overstress the fact that the causes of the necessity for financial reorganization are not the same thing as the causes of the failure of the road as an economic enterprise. Roads fail or experience indifferent success as business ventures because of inadequate traffic, inadequate rates, etc., but no road was ever forced into receivership or bankruptcy by these factors alone when unaccompanied by a financial structure which, by its rigidity, disregarded such inadequacies as genuine possibilities. The necessity for readjusting the contractual obligations of a railroad lies in the precedent failure to recognize as contingent that which is uncertain. The need for reorganization is due to the "fair-weather" character of the financial structure, and to the rigidity of a substantial portion of the capital contracts.

We must, therefore, look for the causes of reorganization in the factors which encourage the choice of rigid debt financing, or, what comes to the same result, those which discourage greater reliance on equity financing. Assuming rational economic (capitalistic) behavior (which, obviously, does not preclude the possibility of error or subsequent failure), we may safely state a priori that the railroads have depended as largely as they have on bond financing because the railroad managements have believed it profitable to do so. This does not mean that the roads could not have sold share capital, or that, viewed in retrospect, they would not have been better off to have done so, but it does mean that at the time there appeared convincing reasons for doing otherwise. Without laboriously listing all the factors which have dictated the substantial use of bonds in spite of their lack

of flexibility, we wish particularly to stress the following combination of circumstances.

1. The issuance of railroad bonds has been encouraged by the advantageous marketing conditions which result from the dependence of certain types of institutional investors on fixed-interest, fixed-principal securities. In defiance of the recognized residual nature of the productive share going to a specialized, relatively non-transferable economic factor, these institutions have avidly (and confidently) absorbed the fixed obligations of railroads. The income from specialized "sunk" capital is a form of economic "rent" which is not per se orderly or assured, and the attempt to give it an artificial semblance of either is a legal legerdmain of doubtful efficacy. A railroad enterprise represents an highly illiquid situation in the nature of things; it is made even more so by the costly "overhead" of a liberal supply of current capital, and by regulatory policies which insist upon minimizing the cash and current assets includable in the rate base. The economic immobility of substantially the entire investment in a railroad enterprise makes efforts to pay a fixed return on a substantial part of the capital employed a precarious practice for the companies. Moreover, the permanency of the investment in railroad plant, much of which is unsalvageable--legal, engineering, overhead costs, etc.--makes it absurd and perilous for the railroads to agree to repay a substantial portion of their invested capital at fixed dates arbitrarily chosen without respect to the conditions which may affect refinancing. It is a moot question whether the greatest social gain results from permitting these other industries--insurance companies, savings banks, and institutional buyers generally--to build their businesses on fixed-interest, maturing, evidences of railroad debt. Ought the railroads be expected to take over the financing worries of other businesses in order that the bondholders, especially the institutional ones, may cling to the fiction that their invested funds are assured of a fixed return and are redeemable in money at a definite maturity date?

The very term "debt" implies the possibility of default and the buyer of railroad debt instruments should contemplate default as a real contingency; he must recognize that the funds which he prefers to regard as a loan are invested by the railroad company in plant, etc., and are subject to economic uncertainties.

For its part, the "public" should view with skepticism, and we believe disavow, any alleged obligation to the holders of railroad bonds greater than the obligation owed to the railroad stockholders. By an excess of conscience toward the railroad bondholders at the expense of seeming indifference toward the stockholders, the public has made itself chargeable with a portion of the responsibility for the preponderance of rigid bond financing in railroad enterprises.

If reorganizations are to be avoided in the future, the cure lies most obviously in the proximate causes of reorganizations--the disparity in the relative rigidity of the legal forms of the capital contracts and of the earnings of capital instruments. To maintain equilibrium there are two possible approaches: (a) stabilization of the earnings, or (b) introduction of flexibility into the contracts. To state the alternatives is to make the decision. Stabilization of earnings is a paradisaical mirage though every effort toward it is commendable and useful in spite of the fact that its attainment will probably prove illusory. Fortunately the possibilities of introducing flexibility into the capital contracts is closer and more easily attainable, even though a certain amount of creative legal work may be necessary in the process.

2. The complacent acceptance of railroad debt financing in the past has undoubtedly been fostered by the ideology of a quasi-guaranteed "fair" return on a "fair value" based upon cost--an ideology which justified the assumption that railroad capital was essentially immutable. The notion of the intrinsic value of property employed in regulated industries rests upon the judicial attempt to overcome the dilemma presented by efforts to use "value" to determine the allowable return when economically the allowed return is the principal factor in determining "value." To avoid the circularity of using the capitalized value of the return as a regulatory criteria when the return itself is in question, the courts cut into the circle by accepting some sort of physical appraisal--cost, cost of reproduction, etc.--as a legally authenticatable fact. If such illusions were ever held as anything more than a rationalization to avoid a regulatory inconsistency, the recent depression should have dispelled all ideas that physical properties have intrinsic value. In so far as any railroad management believed in the judicial (constitutional) guarantee against

confiscation of property devoted to the public use, and at the same time listened to the courts define that property in terms of cost, there could be only one conclusion: Why should the railroad not incur fixed obligations against that property and guarantee a return on the major portion of the principal sums which went into its "cost"? To have concluded otherwise would have been to disregard the whole ideology and rationalization of the industry and its regulation in order to reach a conclusion temperamentally unwelcome to all but the most exemplary of managements, namely, that the venture might prove either unprofitable, unstable, or both, and therefore would not conform to the presuppositions of substantial debt financing.

3. The regulatory practice of allowing a fair return on investment, irrespective of the method of financing, encourages trading on the equity. While the individual enterprise in a regulated industry is not insulated from speculative risks, the superimposed risks of the industry itself are presumably eliminated (or minimized) by the confessed public interest in the maintenance of the particular industry. If, in addition, the regulatory policy persistently stresses the minimum rate at which capital may be obtained without concerning itself with the promises the enterprise makes to secure this "lowest" cost, the incentive toward bond sales and a progressive "thinning of the equity" is greatly aggravated. The regulatory concept of a "fair value" of property devoted to the public use is generally understood, although perhaps not agreed upon as to method of computation; the rate of "fair return" is somewhat less precise in theory, but as a practical question is usually answered in a manner fairly well known and predictable, as well as accepted by the consensus of opinion; but, the proper or ideal ratio of share capital to debt in a regulated enterprise has not received comparable discussion, definition, or agreement. If there is any policy at all, the policy of regulatory commission and courts respecting the "reasonable" or "fair" proportion between evidences of debt and residual equity is vague and barely discernible through the concern over total capitalization; that the policy, if any, is unsound appears from the repeated and persistent necessity for reorganizing the capital structures of the railroads.

As long as bonds bear a lower rate than that allowed to the industry as a fair return on its "lump" value, the managements

within the industry must be tempted by the possible, and (in the midst of regulatory inhibitions everywhere else) the not unforbidden gains from greater "leverage." By making the amount of railway stock relatively small in relation to the railway's property investment, a comparatively small return on the investment may be translated into substantial earnings--per-share of stock. The substantial per-share earnings thus unhealthily secured tend to obscure rather unsatisfactory basic conditions in the industry, and also the fact that really handsome speculative profits from selling the product of the industry are publicly limited.

4. The most diabolical in the combination of circumstances which encourage bond financing of railroads is that, not only is bond financing tempting in the first instance because it does not disturb or dilute control over the property, but, furthermore, under the established practices of the doctrine of relative priority, it does not even seriously disturb practical control when the bonds are defaulted upon. In the theory of corporation finance it is assumed that the fear of increasing their own risks and their own possibilities of loss will sufficiently deter the management from progressively thinning the equity. But the practical history of railroad reorganization has characteristically ignored this presupposition and, in effect, has abolished the presumptive penalty. In the face of great profitableness and a speculative urge toward trading on an increasingly thin equity, application of the relative priority principal reduces the potential private costs (losses) from pushing the practice beyond safe limits. A judicious balancing of the hazards of a financial practice can hardly be expected to achieve socially advisable results, if the dice are loaded in favor of those making the financial decisions. The sale of more and more bonds naturally follows from the apparent profitableness of the practice--a practice from which the compensatory and deterrent unprofitableness has been removed and the expectation of loss minimized. It is hardly necessary to point out that profitableness to the management responsible for making a choice as to financial structure need not always coincide with profitableness to their stockholding constituency; the thing that means most to the management is the confident expectation that they will be enabled by the relative priority principal to survive default and not be dislodged from control.

Since the common stock of a corporation represents every-

thing that remains after deducting the liabilities and the preferred stock, every reduction in the amount of the fixed debt may add an equal amount to the residual value of the common equity. Every reorganization reduction in prior charges brings the possibility of earnings and even dividends on the stock equity that much nearer to realization. No matter what reduction there may be in the par value or number of shares of the stock, its residual nature means that its value is always increased by a positive increment when prior claims are scaled down. If, as is frequently the case, the reduction of fixed charges is offset by an increase in contingent charges (i.e., the bondholders are given fixed or contingent securities equal to the par values formerly held) the stockholders will be brought no nearer to dividends. Nevertheless, the maintenance of control of the property, even if prior charges are not reduced, gives the stockholders and their managements all the collateral advantages of control of a road's traffic, operations and finances together with certain speculative interests in the future of the company. The management of a railroad company is even more clearly gainer by the doctrine of relative priority than are the stockholders, since the management's position is even less likely to be disturbed, considering the probability that any dilution of voting control will prove ineffective in dislodging those who are already fortified by possession.

We are inevitably forced to the conclusion that although the practice of trading on the equity is sound enough in itself, it is unsound when taken in conjunction with the doctrine of relative priority which permits stockholders to retain control after reorganizations necessitated by a bad choice of financial structure. Application of the absolute priority rule would make stockholders and their managements take the consequences of the financing method chosen, or else pay for the privilege of staying in control of the property. It would thereby certainly discourage the financial structures which make reorganization almost a commonplace necessity. If one really could believe that maximizing the portion of railroad capital raised by fixed-interest-bearing maturing evidences of debt is socially advisable, one could accept as a means of fostering that end, the preservation of the equity through the default thus invited. If, however, the end be to maximize flexibility in railroad financial structures with the

hope of avoiding reorganization altogether, or to eliminate where possible the disparities in relative rigidities throughout the economic system, one must favor a rule which makes rigidity unprofitable to the railroad managements. In matters of this sort the "punitive" ideal is not unacceptable if the cost or punishment is known and calculable in advance of the choice which may result in it.

By no means a negligible gain from a return to practical reliance on absolute priority is the fact that the absolute priority rule minimizes the necessity for bargaining between the parties in interest; injects a measure of certainty into the outcome of a reorganization proceeding; and comes the nearest to giving the various investor groups what they bought in priority claims. Much of the dissatisfaction with railroad reorganization procedure under equity was due to the fact that so much had come to depend upon the fiduciary integrity, the initiative and the intelligence of those responsible for negotiating the exchange of securities and distributing the losses. The truth is that it is rather fantastic to have to resort to negotiation and compromise at all between interests who, by previous contracts, have accepted definite responsibilities in exchange for definite rights. The respective priority or residual provisions were inserted in the various capital instruments to induce investors to purchase them. They constitute a part of the consideration offered to the purchasers of the bonds or stocks.

There undoubtedly are occasions when arbitration and compromise may smooth relationships, but the assumption underlying the need and use of negotiation is that some uncertainty or dispute exists. Except, possibly, between complementary divisional liens, the order of preference among the general issues of a specific railroad is fairly clear (at least counsel and bankers think or allege so at the time of offering the issues for sale). In railroad reorganization the flux and uncertainty of the reorganization negotiations is due to the receivership courts having permitted deviations from the absolute priority (contractual) rule. Departure from the pre-established contracts plants the germs for the reorganization conflict. Some interests will then seek priority and others must of necessity grant it, but that both will contend for it is a foregone conclusion. The result has been to

leave the railway investor quite at a loss to know in advance what he can count on when and if his securities are defaulted upon or a reorganization becomes necessary. The things which determine the disposition of his de jure claims come to depend entirely upon de facto bargaining power, the elements of which elude analysis but range from economic coercion to matters more likely to be discussed in books on the psychology of influencing people to one's own advantage.

The encroachment of "equity" into the mortgage forms at another point has been lamented by Lord Bramwell in language which aptly characterizes the equitable reorganization practice. His statement respecting the doctrine of the right of redemption may be applied equally to the doctrine of relative priority:

Whether it would not have been better to have held people to their bargains, and taught them by experience not to make unwise ones, rather than relieve them when they had done so, may be doubtful. We should have been spared the double condition of things, legal rights and equitable rights, and a system of documents which do not mean what they say. But the piety or love of fees of those who administered equity has thought otherwise.¹³

The complex business structure of modern capitalism requires a degree of elasticity not procurable by means of more detailed but still rigid contracts, but it does not follow that contracts "to be observed with fidelity throughout the life of the corporation" are inconsistent with elasticity. It has been said, for example, "There must be room for modification, for waiver or destruction of some rights, and for acquisition of new rights--for adaptation, that is, of the financial structure of the business to the changing nature of that business."¹⁴ The real issue is whether the railroads shall thus continue to make contracts with "their fingers crossed," confessing in advance that waiver and adaptation are inevitable, and that a complete renegotiation concerning the rights to be destroyed and to be acquired is anticipated when and if sanguine hopes fade and default becomes im-

¹³Salt v. Marquess of Northampton (1892) A.C.1. quoted from R. W. Turner, The Equity of Redemption (New York: Macmillan, 1931), p. 118; by F. I. Shaffner, The Problem of Investment (New York: John Wiley & Sons, 1936), p. 110.

¹⁴J. C. Bonbright, "The Problem of Judicial Valuation," Columbia Law Review, XXVII (1927), 515.

minent. The alternative is to make the contracts flexible in the first place and to make the contractual relationship between the security holders as expressive as possible of the uncertainties of business ventures.

The present wave of reorganizations must give consideration to the question of who is to receive the benefits of a return of prosperity to the railroads. Creditors who make sacrifices ought to receive some speculative issue to compensate for accepting lower rates of fixed interest or reduction in par values. It is equally obvious that the senior creditors ought not to be enriched by forfeiture of the equity. But, consideration should also be given to discouraging the circumstances which have necessitated reorganizations in the past, and will continue to do so in the future if traditional financial patterns are accompanied by traditional reorganization doctrines. This is tantamount, as we have already pointed out, to saying that rigidities in substantial portions of the capital contracts should be discouraged, and that an obvious means to that end is to make rigidity less profitable to those in charge of railroad finances. Specifically, this requires that what risks there are in excess trading on a stock equity be allowed to run their course and not be softened by the equity courts. Since the proceedings mitigating the unprofitableness have themselves been intolerable in practice, the immediate gains of such a policy might go surprisingly far in eliminating the invidious procedural elements against which Section 77 was directed.

If a stratified financial structure be desirable, an order of preference is not incompatible with flexibility. (Although one may be dubious of the blessings of stratification, and skeptical of the argument that it permits lower long-run capital costs by catering to a wide variety of investors' fancies, the question is not in issue here.) Income priority may be provided for without creating the necessity for court reorganization. Surely legal counsel can provide more realistic remedies if the contracts are framed in the first place with the expectation that they will end in default. By anticipating the genuine contingency surrounding the economic success of the venture, the deceptive sense of assurance respecting earnings and repayment--an assurance which is incompatible with actually investing or "sinking" funds in capital assets--may be dispelled from the thought of those who build their

own businesses upon the stability of an artificial legal pyramid.

The wide range of discretion allowed the Interstate Commerce Commission under Section 77 invites some more precise definition by the Commission of its ideals and standards; a definition which would inject a measure of certainty into the outcome of the reorganization procedure, avoid dictatorial decisions on issues involving determinable pecuniary differences between specific private interests, and at the same time have a purifying influence on the future of railroad financing methods. Section 77 was properly directed at the abuses and illegitimate developments of the equity reorganization process, but it rests upon the Commission to avoid placing itself under the statute in the position of a selector in specific cases between equally legitimate solutions, or of extending its regulation into the sphere of legitimate financing and entrepreneurial decisions. Charged merely with the "public interest" which often may be achieved within a fairly wide band of variation as to detailed private interests, the Commission will need great rectitude to avoid falling into the easy steps from arbiter, to defender, to a party with a vested interest in the acceptance of a specific plan chosen from among others equally promotive of the public interest. It would be easy to paraphrase a statement of the Commission in connection with the unification program under the Transportation Act of 1920 into a word of caution for its conduct under the sweeping delegation of authority granted by Section 77. The exchange of securities in reorganization is analogous to the exchange of securities in mergers of which the Commission said:

The burden is upon the applicants to justify the justness and reasonableness of the ratios of exchange. . . . We should not be expected to arbitrate to the fraction of a share just what each stockholder [investor] should receive. Many similar applications will probably be filed in the future and if all of these applications, like the instant one, should request us to adjudicate their differences, in the commercial aspects of buying and selling railroad properties [in the exchange of securities in reorganization] the law would probably become unworkable.¹⁵

That necessity and outcome may best be avoided in the case of Section 77 by the Commission's supplying general rules filling

¹⁵Nickel Plate Unification, 105 I.C.C. 425 at 448 (1926).

in the essentially legislative details delegated to it by Congress. The authority of the State in behalf of the public interest is no longer open to dispute, but democracy presupposes that dictatorial review of private cases will be avoided if a general legislative rule applicable to all alike is possible. Railroad reorganization, in its larger aspects, is not unamenable to such rules, and a net gain in the "public interest" may result from reliance on private decisions to advance it, within unequivocal and so far as possible objective standards. There is no rule for the distribution of losses in reorganization which is capable of being applied independently of the caprice of those who apply it except the rule of absolute priority. The market value of securities formula is a sound and acceptable, abstract, basic rule for a predetermined distribution of losses among issues of co-ordinate or conflicting priority. Established, known precedents may be employed for determining allowable fixed charges in particular cases if the general precedent is aimed at a safe minimum instead of the precarious maximum. The public through the acts of its legislatures and commissions may and should disavow any greater obligation to bondholders than to stockholders before default, and any greater solicitude for the stockholders than the prior claimants after default. If, instead of looking for and relying on rules which would make financing and reorganization of railroads subject to a modicum of authoritarian review, the whole problem is to be dumped into the lap of the regulatory agency for disposition of each case on its respective merits and for authoritarian allotment of participation to each conflicting group, private capitalism in the railroad industry will be increasingly empty and meaningless.

